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Treasury releases explanation of tax proposals in Biden budget

The Treasury Department has released its general explanations of tax and revenue proposals as part of President Biden's fiscal year (FY) 2022 budget. The budget proposes numerous tax reforms that, according to the administration, would modernize the nation's tax system, including raising revenue, improving tax administration, and making the Internal Revenue Code more equitable and efficient.

The tax proposals are generally like the ones Biden made during the presidential race in 2020. They include provisions related to:

- High-income individuals
- Extending certain tax benefits to low- and middle-income taxpayers
- Housing and infrastructure
- Clean energy incentives
- Reforms for corporate and international taxation

Biden's budget proposal generally assumes that temporary provisions provided by the Tax Cuts and Jobs Act and available through 2025 will expire, including the Code Sec. 199A deduction for pass-through entities.

Wolters Kluwer

High-income individuals

The administration would make several changes for high-income taxpayers, including increasing the top marginal income tax rate from the current 37% to 39.6% for tax years beginning after 2021. In addition, long-term capital gains and qualified dividends would be taxed at ordinary income rates rather than capital gains rates to the extent the taxpayer's income exceeds $1 million. The threshold amount would be indexed for inflation after 2022.

The FY 2022 budget proposal would eliminate a step-up in basis by a taxpayer of appreciated property held upon death or received as a gift. Instead, the deceased owner or donor of the appreciated asset would realize a capital gain at the time of the transfer. Gain on unrealized appreciation would also be recognized by a trust, partnership or other noncorporate entity that is the owner of property in certain circumstances. The proposal would allow exclusions for tangible personal property and a $1 million per person exclusion from recognition of other unrealized capital gains on property transferred by gift or held at death.

Other changes would apply net investment income tax and self-employment taxes for certain high-income individuals. Most importantly, the proposal would ensure that all pass-through trade or business income is subject to the taxes.

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Families and workers

The Biden budget proposes extending or making permanent several provisions for the tax year to help families and workers during the COVID-19 pandemic:

- Extending changes made to the child tax credit, including the advance refundability of 50% of the credit, through 2025
- Making permanent the expansion of the earned income tax credit for workers without qualifying children
- Making permanent changes to the child and dependent care credit
- Making permanent the expansion of the premium tax credit for health insurance
- Making permanent the increase in the employer-provided childcare tax credit for businesses

Housing and infrastructure

The Biden administration is proposing several changes to encourage building more affordable homes, as well as improvements to America's infrastructure. The proposals include expanding the low-income housing credit by creating an additional type of housing credit dollar amount (HCDA), called Opportunity HCDA, to projects in difficult-to-develop areas. The new markets tax credit would also be permanent, with allocations indexed for inflation after 2026.

The administration is also proposing a new tax credit that would support new construction for sale, substantial rehabilitation for sale, and substantial rehabilitation for existing homeowners in distressed neighborhoods. The neighborhood homes investment credit would be available for constructed or rehabilitated residences that are single-family homes (including homes with up to four dwelling units), condominiums, or residences in a housing cooperative.

The budget proposal would create a new federally subsidized state and local bond to renovate aging schools. The qualified school construction bonds would be like Build American Bonds available in 2009 and 2010, with interest on the bonds taxable. The bondholder's interest would take the form of a tax credit, or the bondholder could receive cash from the bond issuer. The proposal would also expand the category of private activity bonds for highway and freight transfer facilities.

Clean energy

The Biden budget proposes several changes to prioritize clean energy over fossil fuels. This includes extending and enhancing a renewable electricity production credit and a production credit for electricity generation from eligible existing nuclear power facilities. Enhancements would also apply to existing clean energy incentives such as the nonbusiness energy credit under Code Sec. 25C, the credit for construction of energy efficient homes, the carbon oxide sequestration credit, the electric vehicle charging station credit and the deduction for energy efficient commercial building property under Code Sec. 179D.

New tax credits would also be provided for:

- Investing in qualifying electric power transmission property
- Electricity produced from eligible existing nuclear power facilities
- Qualifying advanced energy manufacturing
- Medium- and heavy-duty zero-emission vehicles (for example, electric and fuel cell vehicles)
- Production of sustainable aviation fuel

- Low-carbon hydrogen production using zero-carbon-emissions electricity (renewables or nuclear)
- Qualified disaster mitigation expenditures

The budget would also repeal several credits, deductions and other special provisions that are targeted toward encouraging oil, gas and coal production:

- Tax credit for enhanced oil recovery costs
- Tax credit for oil and gas produced from marginal wells
- Expensing of intangible drilling costs, as well as exploration and developmental costs
- Use of percentage depletion with respect to oil and gas wells and hard mineral fossil fuels
- Capital gains treatment for royalties

Reforming corporate taxation

For corporations, the federal income tax rate would increase from 21% to 28%. The change would apply to tax years beginning after 2021, but a blended rate would apply for tax years beginning in 2021. The change would raise revenue to pay for infrastructure spending proposals included in the FY 2022 budget.

A 15% minimum tax on worldwide book income for corporate income of more than $2 billion is also proposed. The minimum tax would work to reduce the significant disparity between the income reported by large corporations on their federal income tax returns and reported on their financial statements. It would also provide a backstop for the Biden administration's proposed new international tax rules.

Among the proposals to reform the U.S. international tax system are provisions that would:

- Revise the global minimum tax regime for controlled foreign corporation earnings by eliminating the exemption for qualified business asset income and reducing a corporate U.S. shareholder's Code Sec. 250 deduction for the global minimum tax inclusion (GILTI) to 25%
- Reform the taxation of foreign fossil fuel income by repealing the exemption from GILTI for foreign oil and gas extraction income
- Repeal the deduction for foreign-derived intangible income
- Replace the Base Erosion Anti-Abuse Tax with the Stopping Harmful Inversions and Ending Low-Tax Developments rule, which would disallow a deduction to a domestic corporation by reference to low-taxed income of entities that are members of the same financial reporting group with global annual revenues in excess of a *de minimis* threshold
- Limit foreign tax credits from sales of hybrid entities by applying Code Sec. 336(h)(16) to determine the source and character of any item recognized in connection with a direct or indirect disposition of an interest in a specified hybrid entity
- Restrict the deductions of excessive interest of members of financial reporting groups for disproportionate borrowing in the United States
- Provide an expanded general business credit for locating jobs and business activity in the United States and disallowing deductions for expenses paid or incurred in connection with offshoring a U.S. trade or business

Additional revenue raisers

The FY 2022 budget proposal would raise additional revenue by taxing carried interests in partnerships as ordinary income rather than capital gains if the partner's taxable income from all sources exceeds $400,000. The proposal would repeal Code Sec. 1061 for such taxpayers but would require partners in these investment partnerships to pay self-employment taxes on such income.

An additional revenue raiser would allow the deferral of gain up to an aggregate amount of $500,000 for each taxpayer ($1 million in the case of married individuals filing a joint return) each year for like-kind real property exchanges. Any gains from like-kind exchanges of more than $500,000 (or $1 million in the case of married individuals filing a joint return) during a tax year would be recognized by the taxpayer in the year the taxpayer transfers the real property subject to the exchange.

The budget proposal would also make permanent Code Sec. 461(l) excess business loss limitation on noncorporate taxpayers for tax years beginning after 2026.

Compliance and tax administration

Finally, the FY 2022 budget proposal would improve tax compliance and tax administration. For example, the administration would include an increase in the IRS budget for enforcement and operations. It would also create comprehensive financial account reporting rules requiring financial institutions to report data on financial accounts in an information return, including crypto asset exchanges and custodians. The proposal would also give the Treasury Department the explicit authority to regulate all paid preparers of federal tax returns, including mandatory minimum competency standards. ◆

Adopting and contributing to solo 401(k)s for 2020 in 2021

Starting in 2021, qualified plans can be adopted after the close of the tax year, provided it is before the due date of the sponsor's tax return (including extensions). Employers who were willing to accept the limits of a Simplified Employee Pension (SEP) plan always had the late-adoption option, but qualified plans are much more flexible than SEP plans, so this provides an attractive alternative for late adopters.

An overlooked SECURE Act (P.L. 116-94) change is that employers can adopt new qualified plans and make deductible contributions after the close of the tax year. They must act before the due date for filing the employer's return (including extensions). That means for solo 401(k) plans, individuals could adopt a plan and make contributions by April 15, 2021, for the 2020 tax year, and delay this deadline further with an extension.

SECURE Act change

An employer must have adopted a qualified plan under Code Sec. 401 by the end of its tax year for a contribution to be deductible for that tax year. Qualified plans include pension plans, profit-sharing plans, stock bonus plans, annuity plans, and qualified cash or deferral plans (401(k) plans).

Employers that lack a plan but want to contribute for the previous year can adopt a SEP under Code Sec. 408(k) as late as the due date for the employer's return (including extensions) for the tax year. Although SEPs and defined contribution qualified plan contributions are generally subject to the same limits, SEPs do not have a cash or deferral option, which is a significant disadvantage.

> "A business owner with no common-law employees does not need to perform nondiscrimination testing."

Effective for plan years beginning after Dec. 31, 2019, an employer that adopts a qualified plan after the close of a tax year but before the due date for filing its return for the tax year (including extensions) may treat the plan as having been adopted as of the last day of the tax year (Code Sec. 401(b)(2), added by P.L. 116-94).

This change puts qualified plans, including 401(k)s, on par with SEP plans for these purposes.

What are solo 401(k)s?

As discussed in IRS Publication 560, *Retirement Plans for Small Business (SEP, SIMPLE and Qualified Plans)*, a solo 401(k) plan is a one-participant traditional 401(k) plan covering a business owner with no employees. These plans mostly have the same rules and requirements as any other 401(k) plan. They can include the owner's spouse, or partners and their spouses.

A one-participant plan is a plan that, on the first day of the plan year, meets one of the following conditions:

- Covers only one individual (or the individual and the individual's spouse) and the individual (or the individual and the individual's spouse) owned 100% of the plan sponsor (whether or not incorporated)
- Covers only one or more partners (or partners and their spouses) in the plan sponsor

One-participant plans are exempt from the blackout notice requirement and diversification requirement, and are not required to provide periodic benefit statements (Code Sec. 401(a)(35)(E)(iv); Reg. §1.401(k)-1(a)(6)).

A business owner with no common-law employees does not need to perform nondiscrimination testing. The no-testing advantage doesn't apply if the owner hires employees.

Due to the simplicity of one-participant plans, a prototype plan (whether or not designed specifically to cover just the owner of the plan) will nearly always work as the plan document. Many financial firms offer solo 401(k)s.

Contributions

The business owner is both employee and employer in a 401(k) plan, and can contribute to the plan in both capacities. The owner can contribute:

- Elective deferrals up to 100% of compensation (earned income in the case of a self-employed individual) up to the annual contribution limit ($19,500 for 2021, or $26,000 if age 50 or older) (Notice 2020-79, I.R.B. 2020-46, 1014)

- Employer nonelective contributions up to 25% of compensation as defined by the plan (for self-employed individuals, the amount is determined by using an IRS worksheet and, in effect, limits the deduction to 20% of earned income).

Elective deferrals are treated as ordinary compensation for deduction purposes and expand the employer's retirement contribution deduction limit (25% of compensation or 20% of earned income), while not using up the limit. Thus, an individual who adds a solo 401(k) feature to a profit-sharing or money purchase plan can contribute significantly more.

Compliance tip

Self-employed participants may defer against advances or draws. A partner or self-employed person's income is deemed available to them on the last day of their tax year. Because an employee must have a deferral election in place before compensation is available, a self-employed person may not make a cash or deferred election with respect to compensation for a partnership or sole proprietorship tax year after the last day of that year. If a partnership provides for cash advance payments to the partner during the tax year based on the value of the partner's services prior to the date of payment (and not exceeding a reasonable estimate of the partner's earned income for the tax year), the individual can defer a portion of these advances, though their final compensation has not yet been determined (Reg. §1.401(k)-1(a)(6)(iv)). If self-employed people want to maximize their contributions, they must wait until their final compensation has been determined, which is permissible provided the election was in place as of the last day of the tax year.

Generally, contributions to qualified plans must be in the tax year the employer takes the deduction. There is a grace period, however, that allows employer contributions until the due date of the employer's tax return, plus extensions. In the case of a sole proprietor, this is when the Form 1040 is due (Oct. 15, with an extension (Code Sec. 404(a)(6)). Note that the owner cannot make matching contributions or elective deferrals during the grace period for the prior year unless they are attributable to services performed prior to the end of the employer's tax year (Rev. Rul. 2002-46, 2002-2 CB 117).

Unrelated business taxable income

As with a self-directed IRA, income from a solo 401(k) may be treated as unrelated business taxable income (UBTI) if it is generated by an active business directly owned by the plan. Generally, such businesses involve real estate due to the generous exemptions from UBTI for such income. One difference between a solo 401(k) and a self-directed IRA in this regard is that unrelated debt-financed income is exempt from inclusion in UBTI for a qualified plan, such as a 401(k), but not for an IRA (Code Sec. 501(c)(9)). Consequently, a solo 401(k) will have an advantage if the enterprise uses nonrecourse debt to finance the purchase of real estate.

A solo 401(k) with UBTI must report on Form 990-T, *Exempt Organization Business Income Tax Return*. For a retirement plan or arrangement, the due date is the 15th day of the fourth month after the tax year (for other tax exempts, it is the fifth month). (Instructions for Form 990-T, *Exempt Organization Business Income Tax Return* (and proxy tax under section 6033(e)).

Conclusion

Solo 401(k)s make sense in comparison to SEPs, especially for maximizing contributions. One of the advantages of a SEP was that it could be adopted and contributions could be made after the end of the tax year, but that is now true of 401(k)s as well. ◆

Final required minimum distribution table regulations

The IRS has updated its required minimum distribution (RMD) life expectancy and distribution period tables for IRA owners and retirement plan participants. The change is effective for the 2022 RMD year. A transition rule applies for certain beneficiaries of deceased owners who use a life expectancy distribution period determined before 2022 (Reg. §1.401(a)(9)-9, as updated by T.D. 9930 (Nov. 5, 2020)).

The new life expectancy and distribution period tables generally reflect longer life expectancies. For example, a 72-year-old IRA owner who applies the pre-2022 Uniform Lifetime Table to calculate RMDs uses a life expectancy of 25.6 years. Applying the new Uniform Lifetime Table, the life expectancy is 27.4 years. For someone with a $100,000 balance at the close of the previous year, the RMD amount would be $3,650 rather than $3,906.

The effect of these changes is to lower RMD amounts generally, at least in the earlier years of retirement. This change will allow people who can afford to go without RMDs to retain larger amounts in their retirement plans to account for the possibility they may live longer.

> "The updated life expectancy tables apply for distribution calendar years beginning on or after Jan. 1, 2022."

Life expectancy and distribution period tables

The RMD amount for any year is the account balance at the end of the immediately preceding calendar year divided by a distribution period found in one of these life expectancy tables:

- Table I (Single Life Expectancy)
- Table II (Joint Life and Last Survivor Expectancy)
- Table III (Uniform Lifetime)

Table I. This table is for years after the owner's death for designated beneficiaries using their own life expectancy to determine their applicable distribution period. Table I is also for beneficiaries who are not individuals (e.g., estates or charities) using the IRA owner's or plan participant's life expectancy if the owner or participant died on or after the required beginning date.

For designated beneficiaries using their own life expectancy, the first distribution is calculated based on the beneficiary's age as of the beneficiary's birthday in the first calendar year immediately following the calendar year of the employee or IRA owner's death. After the first distribution year, life expectancy is reduced by one for each subsequent year. However, if the beneficiary is the owner's surviving spouse and the sole designated beneficiary, subsequent distribution years use the spouse's current age throughout the spouse's life.

Note that RMDs for 2020 are waived, so no actual RMDs are distributed. However, the waiver does not affect the distribution period calculation for 2020. Also, the SECURE Act eliminated the life expectancy rule for most designated beneficiaries, starting with beneficiaries of employees or IRA owners who died after 2019 (Notice 2020-51, 2020-29 IRB 72).

For a non-designated beneficiary where the owner dies on or after the required beginning date, the owner's life expectancy for Table I is used. The owner's age as of their birthday in the year of death is used. The applicable period is reduced by one for each subsequent year. This method is also used if it results in a longer distribution period for a designated beneficiary than using the designated beneficiary's life expectancy.

Table II. This table is used by a living individual whose spouse is more than 10 years younger and the sole beneficiary. For the first distribution, the ages of the owner and spouse as of their birthdays in the year the owner turns age 72 are used. The combined life expectancy is at the intersection of these ages. For example, if the initial RMD year is 2021, the owner's and spouse's ages as of their birthdays in 2021 are used. For each subsequent year, their ages as of their birthdays in the subsequent year are used.

Table III. This table is used for living individuals except those covered by Table II. For the first distribution, the IRA owner's age as of their birthday is used. For each subsequent year, the owner's age as of their birthday in the subsequent year is used.

Effective date of new tables

The updated life expectancy tables apply for distribution calendar years beginning on or after Jan. 1, 2022. Individuals who re-determine their life expectancy each year (living IRA owners or employee plan participants and their surviving spouses who are sole beneficiaries) start using the new tables for 2022 RMDs.

The transition is more complicated for individuals whose distribution periods are based on a historic life expectancy determined at the initial distribution and then reduced by one each subsequent year. Their original life expectancy must be reset starting with 2022 RMDs (Reg. §1.401(a)(9)-9(f)).

Conclusion

The updated tables are welcome. Other RMD changes for 2020 and 2021, including the 2020 RMD waiver and the shift from age 70½ to age 72 for the first RMD year, may seem more significant than the updated tables. However, the new tables will apply to all RMD recipients, beginning with 2022 RMDs. ◆

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